[JOINT COMMITTEE PRINT]

# DESCRIPTION OF TAX BILLS
## (S. 1239, S. 1821, S. 2078, S. 2409, S. 2484, S. 2611, H.R. 1961, and H.R. 2792)

SCHEDULED FOR A HEARING

BEFORE THE

## SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

## SENATE COMMITTEE ON FINANCE

ON JULY 12, 1988

---

PREPARED BY THE STAFF

OF THE

## JOINT COMMITTEE ON TAXATION

JULY 11, 1988

U.S. GOVERNMENT PRINTING OFFICE

86-801 WASHINGTON : 1988 JCS-12-88

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

J862-23
S362-12

# CONTENTS


| | Page |
|---|---|
| INTRODUCTION | 1 |
| I. SUMMARY | 3 |
| II. DESCRIPTION OF THE BILLS | 7 |
| 1. S. 1239 (Senators Armstrong and Daschle): Tax treatment of short-term loans of small banks | 7 |
| 2. S. 1821 (Senator Breaux): Treatment of seafood processors for employment tax purposes | 9 |
| 3. S. 2078 (Senator Armstrong): Majority voting requirement for ESOPs | 10 |
| 4. S. 2409 (Senator Bumpers): Designation of overpayments and contributions on tax return for the Organ Transplant Trust Fund | 13 |
| 5. S. 2484 (Senators Danforth, Baucus, and others): Extension and modification of research credit | 15 |
| 6. S. 2611 (Senator Cranston): Disclosure of certain tax return information to Veterans' Administration | 23 |
| 7. H.R. 1961: Portability of pension plan benefits | 24 |
| 8. H.R. 2792: Tax treatment of Indian fishing rights | 30 |

## INTRODUCTION

The Senate Finance Subcommittee on Taxation and Debt Management has scheduled a public hearing on July 12, 1988 on the following eight bills: (1) S. 1239 (tax treatment of short-term loans of small banks); (2) S. 1821 (treatment of seafood processors for employment tax purposes); (3) S. 2078 (majority voting requirement for ESOPs); (4) S. 2409 (designation of overpayments and contributions on tax return for the Organ Transplant Trust Fund); (5) S. 2484 (extension and modification of research credit); (6) S. 2611 (disclosure of certain tax return information to the Veterans' Administration); (7) H.R. 1961 (portability of pension plan benefits); and (8) H.R. 2792 (tax treatment of Indian fishing rights).

The first part of the pamphlet[1] is a summary. The second part is a description of the bills, including present law, explanation of the bills, and effective dates.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Bills (S. 1239, S. 1821, S. 2078, S. 2409, S. 2484, S. 2611, H.R. 1961, and H.R. 2792)* (JCS-12-88), July 11, 1988.

## I. SUMMARY

### 1. S. 1239—Senators Armstrong and Daschle

### Tax Treatment of Short-Term Loans of Small Banks

Under present law, certain taxpayers must accrue as interest any acquisition discount and stated interest on short-term obligations. For taxpayers that are not subject to this accrual requirement, present law defers the deduction of net direct interest expense with respect to any short-term obligations until the interest income on such short-term obligations is recognized.

The bill would exempt loans made by small banks in the ordinary course of the bank's trade or business from the rules applicable to short-term obligations requiring accrual of any acquisition discount, accrual of stated interest, and the deferral of interest expense. This provision would be effective for loans acquired after July 18, 1984. The bill also would change the effective date of the provision that requires the accrual of stated interest on short-term obligations.

### 2. S. 1821—Senator Breaux

### Treatment of Seafood Processors for Employment Tax Purposes

Under present law, an employer is required, with respect to its employees, to (1) withhold the employees' share of the Federal Insurance Contributions Act (FICA) tax, (2) pay its share of the FICA tax, (3) pay the Federal Unemployment Tax Act (FUTA) tax, and (4) withhold Federal income taxes. FICA and FUTA taxes and Federal income tax withholding apply only with respect to employees. In general, employees are exempt from the tax on self-employment income because they are subject to FICA taxes.

Under the bill, certain seafood processors are excluded from the definition of employees for purposes of the FICA tax, FUTA tax, and Federal income tax withholding, and thus are not subject to such provisions; instead, such seafood processors are subject to the tax on self-employment income. The bill generally applies beginning on January 1, 1988.

### 3. S. 2078—Senator Armstrong

### Majority Vote Requirement for ESOPs

An employee stock ownership plan (ESOP) is a type of qualified pension plan. An ESOP must be designed to invest primarily in employer securities.

Under present law, the decision whether to establish an ESOP is within the discretion of the employer, except in the case of a collectively bargained plan. Present law imposes voting requirements

with respect to employer securities allocated to the accounts of ESOP participants and beneficiaries. If the employer maintaining an ESOP has a registration-type class of securities, the ESOP must provide that each participant and beneficiary is entitled to direct the plan trustee how to vote the shares allocated to the participant's or beneficiary's account. If the employer does not have a registration-type class of securities, then each participant and beneficiary is entitled to direct the trustee how to vote shares allocated to his or her account only with respect to certain enumerated issues.

In general, the bill would provide that (1) a plan will not be qualified as an ESOP unless the establishment of the plan is approved by a majority of the employees of the employer establishing the plan, and (2) the Treasury Department may provide that the voting requirements with respect to ESOPs are not satisfied if the voting rights of any participant or beneficiary are not substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities.

The majority vote requirement would be effective with respect to plans established after the date of enactment of the bill. The voting rights requirement would be effective with respect to securities acquired after the date of enactment.

### 4. S. 2409—Senator Bumpers

### Designation of Overpayments and Contributions on Tax Return for the Organ Transplant Trust Fund

Under present law, individual taxpayers may elect on their income tax return to allocate $1 ($2 on a joint return) of their tax liability to a fund established to provide financing to Presidential election campaigns. Federal tax law does not permit taxpayers to make contributions for charitable or other purposes through their Federal income tax returns.

The bill would provide that taxpayers could designate on their tax returns all or a portion of their tax refunds (or could make contributions with their returns) to a new trust fund that would defray the cost of necessary organ transplants. The designation of contributions to the trust fund would be effective for returns filed for taxable years ending after the date of enactment.

### 5. S. 2484—Senators Danforth, Baucus, Wallop, Kerry, Heinz, Durenberger, Chafee, Mitchell, Boren, McCain, Riegle, Bond, Cranston, Wilson, Symms, Bingaman, Rudman, Sanford, DeConcini, Weicker, Grassley, Heflin, and Lautenberg

### Extension and Modification of Research Credit

A 20-percent income tax credit is allowed for the amount of qualified research expenditures paid or incurred by a taxpayer during the taxable year that exceeds the average amount of the taxpayer's qualified research expenditures in the preceding three taxable years (the "base period"). The credit also applies to certain payments to universities for basic research. Under present law, the credit is scheduled to expire after December 31, 1988.

The incremental credit is available only for research expenditures paid or incurred by the taxpayer in carrying on an existing trade or business. Thus, under present law no credit is available to a start-up company for research the results of which are intended to be used in its future business activities, or to an existing business for research expenditures incurred for purposes of developing a new line of business.

The bill would make permanent the incremental research credit and the university basic research credit.

Under the bill, a taxpayer could elect either of two methods for computing the incremental research credit. Under either method, a specified credit rate would apply to the amount of the taxpayer's qualified research expenditures in the current year that exceeds a fixed base period amount (subject to an annual adjustment to reflect increases in the GNP growth rate), rather than a moving base period amount as under present law. The credit would be 20 percent of the excess of current-year expenditures over the base, or seven percent of the excess of current-year expenditures over 75 percent of the base.

Also, the bill would modify the present-law trade or business test to extend eligibility for credit to qualified research expenditures where the research results are intended to be used in the active conduct of a future trade or business of the taxpayer.

The bill would be effective for taxable years beginning after December 31, 1988.

## 6. S. 2611—Senator Cranston

### Disclosure of Certain Tax Return Information to Veterans' Administration

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, with exceptions for authorized disclosure in certain enumerated instances. Any unauthorized disclosure is subject to criminal penalties and civil damages.

The bill[2] would allow disclosure of certain tax return information to the Veterans' Administration for the purpose of determining eligibility for (and the amount of) veterans' pension and other benefits. The bill would be effective on the date of enactment.

## 7. H.R. 1961

### Portability of Pension Plan Benefits

There is no precise definition of portability of pension benefits, and the term is often used to refer to a broad variety of concepts. In general, the term portability refers to an individual's ability to maintain his or her pension benefits after changing employment. Under present law, the social security system provides the greatest degree of portability of retirement benefits. The social security system covers virtually all workers, and benefits are based on all covered employment.

---

[2] S. 2611 was favorably reported by the Senate Committee on Veterans' Affairs on July 6, 1988 (S. Rpt. 100–412), and was placed on the Senate Calendar.

In the private pension system, present law includes several provisions intended to facilitate portability by permitting individuals who receive a distribution of benefits to keep the benefit in a tax-favored retirement arrangement (this concept is often referred to as portability of assets). The most significant of these provisions is the ability to roll over pension distributions to an individual retirement account (IRA). In addition, the withdrawal restrictions applicable to tax-qualified retirement plans and the rules regarding taxation of benefits facilitate the ability to keep retirement funds in a tax-favored arrangement until retirement, inasmuch as these provisions generally are designed to provide incentives for individuals to retain pension savings until retirement.

The bill[3] modifies the rules relating to distributions from qualified plans, qualified annuity plans, tax-sheltered annuity contracts, and IRAs. The bill provides that (1) in certain circumstances direct transfers to IRAs are required in lieu of distribution; (2) the Treasury Department may permit the distribution of employee contributions to be rolled over; (3) distributions from IRAs must be made with the consent of the IRA owner; (4) certain spousal rights to survivor benefits are required for IRAs and tax-sheltered annuity contracts; (5) certain nontax provisions are made applicable to pension plans consisting of one or more IRAs; and (6) the rules relating to salary reduction SEPs are modified. The bill is effective for years beginning after 1991.

## 8. H.R. 2792

### Tax Treatment of Indian Fishing Rights

Various treaties, Federal statutes, and executive orders reserve to Indian tribes (mostly in the West and Great Lakes regions) rights to fish for subsistence and commercial purposes both on and off reservations. Because the treaties, statutes, and executive orders were adopted before passage of the Federal income tax, they do not specifically address whether income derived by Indians from protected fishing activities is exempt from taxation.

The bill[4] would provide that income derived by certain Indians and Indian-owned entities from the exercise of fishing rights protected by treaties, Federal statutes, or executive orders is exempt from Federal and State tax, including income, social security, and unemployment compensation insurance taxes. The bill would apply to all taxable years beginning before or after the date of enactment as to which the period of assessment has not expired.

---

[3] H.R. 1961 was reported, with amendments, by the House Committee on Education and Labor on June 7, 1988 (H. Rpt. 100–676, Part 1).

[4] H.R. 2792 was passed by the House of Representatives on June 20, 1988. (See also H.Rpt. 100–312, Part 2.)

## II. DESCRIPTION OF THE BILLS

### 1. S. 1239—Senators Armstrong and Daschle

### Tax Treatment of Short-Term Loans of Small Banks

#### *Present Law*

***Required accrual of interest on short-term loans***

Under present law, certain taxpayers must accrue as interest (computed on a daily basis) any acquisition discount and stated interest on short-term obligations, i.e., obligations with a fixed maturity date of not more than one year from the date of issue (Code sec. 1281). This accrual requirement applies to accrual-basis taxpayers, banks, regulated investment companies (mutual funds), common trust funds, dealers in short-term obligations, taxpayers that designate the short-term obligations as part of a hedge, and certain taxpayers that stripped an obligation.

The requirement under section 1281(a)(1) for accrual of interest attributable to acquisition discount generally is effective for obligations acquired after July 18, 1984. Taxpayers, however, could elect to apply the provision to all short-term obligations owned by the taxpayer for its first taxable year ending after July 18, 1984; an electing taxpayer was permitted a five-year spread of the income attributable to the change in accounting method for short-term obligations. The accrual of stated interest on short-term obligations under section 1281(a)(2) is effective for obligations acquired after September 27, 1985.[5]

***Deferral of interest deduction allocable to short-term obligations***

For taxpayers that are not required to accrue acquisition discount and stated interest on short-term obligations, present law defers the deduction of net direct interest expense with respect to any short-term obligations until the interest income on such short-term obligations is recognized (sec. 1282). Net direct interest expense means the excess, if any, of the amount of interest paid or accrued during the taxable year on indebtedness incurred or continued to purchase or carry a short-term obligation, over the aggregate amount of interest includible in gross income for the taxable year with respect to such obligation.

#### *Explanation of the Bill*

The bill would exempt loans made by a small bank in the ordinary course of the bank's trade or business from the rules applica-

[5] The Technical Corrections Act of 1988 (S. 2238), sec. 118(c)(1), would make this provision effective for obligations acquired after December 31, 1985.

ble to short-term obligations requiring accrual of any acquisition discount, accrual of stated interest, and the deferral of interest expense. A bank would be considered a small bank for this purpose if, in general, its average annual gross receipts do not exceed $5 million. This provision would be effective for obligations acquired after July 18, 1984.

For entities not affected by the provision above, the bill would change the effective date of the provision which requires the accrual of stated interest on short-term obligations under section 1281(a)(2). Under the bill, such accrual would be required for obligations acquired after October 22, 1986.

## 2. S. 1821—Senator Breaux

### Treatment of Seafood Processors for Employment Tax Purposes

#### *Present Law*

Under present law, an employer is required, with respect to its employees, to (1) withhold the employees' share of the Federal Insurance Contributions Act (FICA) tax (sec. 3102), (2) pay its share of the FICA tax (sec. 3111), (3) pay the Federal Unemployment Tax Act (FUTA) tax (sec. 3301), and (4) withhold Federal income taxes (sec. 3402). In general, employees are exempt from the tax on self-employment income (sec. 1401) because they are subject to FICA taxes (sec. 1402(c)).

In taxable years beginning in 1988 and 1989, the rate of tax on self-employment income is 13.02 percent; in taxable years beginning after 1989, the rate is 15.3 percent. The comparable FICA rates (total of employer and employee shares) for the same periods are 15.02 percent and 15.3 percent, respectively. Certain other adjustments apply to the tax on self-employment income that generally are intended to equalize the burden of the FICA taxes and the tax on self-employment income for taxable years beginning after 1989.

The FUTA tax only applies with respect to employees. The minimum net FUTA tax imposed on employees is 0.8 percent (0.6 percent in calendar years after 1990) of the first $7,000 of wages paid to each employee during the year.

Federal income tax withholding only applies with respect to employees.

#### *Explanation of the Bill*

Under the bill, certain seafood processors are excluded from the definition of employees for purposes of the FICA tax, FUTA tax, and Federal income tax withholding and thus are exempt from such provisions; instead, such seafood processors are subject to the tax on self-employment income. For this purpose, the term seafood processor means an individual whose remuneration is based on the quantity of fish or shellfish the individual peels, picks, heads, shucks, fillets, or otherwise processes.

#### *Effective Date*

The provisions with respect to FICA and FUTA taxes apply to services performed after December 31, 1987. The provisions with respect to income tax withholding and the tax on self-employment income apply to taxable years ending after December 31, 1987.



86-801 - 88 - 2

## 3. S. 2078—Senator Armstrong

## Majority Vote Requirement for ESOPs

### *Present Law*

An employee stock ownership plan (ESOP) is a type of qualified pension plan. An ESOP must be designed to invest primarily in securities of the employer maintaining the plan. An ESOP is either a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan under which employer securities are held for the benefit of employees participating in the plan and their beneficiaries. ESOPs are subject to special requirements in addition to the rules generally applicable to all qualified plans.

ESOPs receive the same favorable tax treatment available with respect to all qualified plans. Thus, an employer maintaining an ESOP receives a current tax deduction for contributions to the ESOP, and plan participants are not taxed on benefits provided by the ESOP until the benefits are actually distributed. In addition, the deduction and contribution limits applicable to ESOPs are generally higher than those applicable to similar types of qualified plans.

For purposes of the ESOP rules, the term employer securities means common stock of the employer (or a member of the controlled group of the employer) that is readily tradable on an established securities market. If there is no such stock, then the term employer securities means common stock issued by the employer (or controlled group member) having a combination of voting power and dividend rights equal to or greater than the class of common stock of the employer (or controlled group member) having the greatest voting power, and that class of common stock of the employer (or controlled group member) having the greatest dividend rights. Employer securities also include certain convertible preferred stock. As long as the stock meets these requirements, an ESOP may hold a special class of stock designed for the ESOP, which is not held by any other shareholder.

Under present law, the decision whether to establish an ESOP or another type of qualified plan is within the discretion of the employer, except in the case of a collectively bargained plan. Present law permits the employer to terminate another qualified plan and replace it with an ESOP. For example, under present law, an employer may terminate a defined benefit plan, and transfer any reversion (i.e., excess assets remaining after satisfaction of all liabilities to employees upon plan termination) to an ESOP. Present law facilitates such transactions by providing that, to the extent the reversion is transferred to an ESOP, it is not includible in the gross income of the employer or subject to the 10-percent excise tax on employer reversions (sec. 4980).

Under present law, ESOPs are subject to certain voting requirements with respect to the stock allocated to the accounts of plan participants and beneficiaries. The particular requirements depend on whether the employer has a registration-type class of securities. In general, a registration-type class of securities is a class of securities that is required to be registered under the Securities Exchange Act of 1934.

An ESOP that is maintained by an employer that has a registration-type class of securities is required to provide that each participant and beneficiary is entitled to direct the trustee how to vote shares allocated to the participant's or beneficiary's account. Thus, in such cases, each participant and beneficiary is entitled to direct voting with respect to every issue on which there is a vote by shareholders.

More limited voting requirements apply if the employer does not have a registration-type class of securities. In such cases, an ESOP is required to provide that plan participants and beneficiaries are entitled to direct the trustee how to vote shares allocated to the participant's or beneficiary's account only with respect to certain enumerated issues. These issues are the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all the assets of a trade or business, or such similar transactions as the Treasury Department may prescribe.

## *Explanation of the Bill*

### *In general*

In general, the bill would provide that (1) a plan will not be qualified as an ESOP unless the establishment of the plan is approved by a majority of the employees of the employer establishing the plan, and (2) the Treasury Department may require that the voting requirements applicable to ESOPs are not satisfied unless the voting rights under the plan are substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities.

### *Majority vote requirement*

The bill would provide that a plan is not qualified as an ESOP unless a majority of the employees of the employer establishing the plan approve the establishment of the plan pursuant to an election conducted by secret ballot. The employer would be required to notify employees of all material facts concerning the plan, including whether assets will be transferred to the plan from any other plan and whether the plan will replace such other plan, the terms of the plan, and the terms of the plan (if any) from which the assets are being transferred. The election would be required within a reasonable period after the required notice is provided.

### *Voting requirements*

Under the bill, the Treasury Department would be authorized to provide that the voting requirements applicable to ESOPs are not met if the voting rights of any participant or beneficiary in securities allocated to the account of such participant or beneficiary are

not substantially similar to the voting rights of other persons who hold the same class of securities or substantially similar securities.

### *Effective Date*

The provision relating to a majority vote of employees on establishment of an ESOP would be effective with respect to plans established after the date of enactment of the bill.

The provision relating to the voting requirements applicable to an ESOP would be effective with respect to employer securities acquired after the date of enactment of the bill.

## 4. S. 2409—Senator Bumpers

### Designation of Overpayments and Contributions on Tax Return for the Organ Transplant Trust Fund

#### *Present Law*

Under present law, individual taxpayers may elect to allocate $1 ($2 on a joint return) of their tax liability to the Presidential Election Campaign Fund, a fund established to provide financing to the campaigns of presidential and vice-presidential candidates (Code sec. 6096). The election is made on the first page of the taxpayer's return. An election to make an allocation to the fund neither increases nor decreases the taxpayer's liability, but merely determines whether the allocated amount will be used by the Federal Government for campaign funding.

No other provisions of Federal tax law permit taxpayers to designate for what purpose the amount of tax owed is to be used by the Government. Present law does not permit taxpayers to make contributions for charitable or other purposes through their Federal income tax return.

The Commissioner of Internal Revenue, in the instructions to Form 1040, has encouraged taxpayers to include with their tax return voluntary contributions to reduce the public debt. Taxpayers wishing to do so must enclose a separate check payable to the Bureau of Public Debt.

#### *Explanation of the Bill*

***Designation of amounts for Organ Transplant Trust Fund***

Under the bill, taxpayers[6] entitled to an income tax refund could irrevocably designate all or any portion of the refund as a contribution to the National Organ Transplant Trust Fund, a trust fund to be established by the bill within the United States Treasury. The bill would require that the designation appear on the first page of the return.

Taxpayers not entitled to a refund, or who wished to make a contribution to the Fund in excess of their refund, could include an additional amount with their return and designate this as a contribution to the Fund. The designation would not increase or decrease the tax liability of a taxpayer for the year covered by the return.

***Disposition of amounts in Trust Fund***

Under the bill, each State would establish a program to receive payments from the Fund and to provide financial assistance to individuals with a medical condition for which an organ transplant

[6] It is intended that this provision apply only to individual taxpayers.

procedure is medically necessary, who lack the financial resources to pay for such procedures. A State also could use funds from the Trust to pay for costs incurred by the State's chief health officer to publicize the availability of the Trust Fund and to solicit contributions to the Fund, except that such payments could not exceed five percent of the total payments received by the State from the Trust Fund for the year.

Specific rules and procedures relating to State residency and the medical and financial eligibility of individuals for benefits under a State's program, which medical expenses would be eligible for payments from the program, the maximum amounts payable, the terms and conditions under which payment will be made to eligible individuals, and other relevant determinations, would be prescribed by regulations issued by the chief health officer of each State.

Amounts in the National Organ Transplant Trust Fund would be disbursed by the Secretary of the Treasury to those States which had been certified by the Secretary of Health and Human Services as carrying out their programs in accordance with the bill and fully accounting for the money received from the Fund for the previous year. Expenses incurred by the Treasury Department in administering the program also would be payable out of the Fund.

### *Effective Date*

The designation of contributions to the Trust Fund would be effective for returns filed for taxable years ending after the date of enactment. The Trust Fund would be established on the date of enactment.

**5. S. 2484—Senators Danforth, Baucus, Wallop, Kerry, Heinz, Durenberger, Chafee, Mitchell, Boren, McCain, Riegle, Bond, Cranston, Wilson, Symms, Bingaman, Rudman, Sanford, DeConcini, Weicker, Grassley, Heflin, and Lautenberg**

**Extension and Modification of the Research Credit**

***Present Law***

***Current deduction for certain research expenditures***

***General rule***

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new product or improve a production process, must be capitalized. However, Code section 174 permits a taxpayer to elect to deduct currently the amount of "research or experimental expenditures" incurred in connection with the taxpayer's trade or business. For example, a taxpayer may elect to deduct currently the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

The section 174 election does not apply to expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research.[7] Thus, for example, the total cost of a research building or of equipment used for research cannot be deducted currently under section 174 in the year of acquisition. However, the amount of depreciation (cost recovery) allowance for a year with respect to depreciable property used for research may be deducted under sections 167 and 168. Pursuant to the Tax Reform Act of 1986 (the "1986 Act"), machinery and equipment used for research and experimentation are classified as five-year recovery property.

***Qualifying expenditures***

The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election, except to exclude certain costs. Treasury regulations (sec. 1.174-2(a)) define this term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a

[7] The statute also excludes expenditures to ascertain the existence, location, extent, or quality of mineral deposits (including oil and gas) from eligibility for section 174 elections (sec. 174(d)). However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

plant process, a product, a formula, an invention, or similar property," and also the costs of obtaining a patent on such property.

The present regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

***Minimum tax rules***

For purposes of the individual alternative minimum tax, the excess of research expenditures that are expensed under section 174 over 10-year amortization is a preference item. In the case of research expenditures incurred by corporations, expensing under section 174 does not give rise to a minimum tax preference item.

***Credit for increasing certain research expenditures***

*Overview*

A 20-percent income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (Code sec. 41). Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the preceding three taxable years (the "base period").[8]

A taxpayer's research expenditures eligible for the 20-percent incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf.

Under present law, the credit is scheduled to expire after December 31, 1988.

*Definition of research for credit purposes*

*In general.*—The incremental credit is directed at research undertaken for the purpose of discovering information that is technological in nature and when applied is intended to be useful in developing a new or improved business component for sale or use in the taxpayer's trade or business. In addition, research is eligible for the credit only where substantially all the activities of the research constitute elements of a process of experimentation relating to functional aspects of the business component.

*Research.*—Research expenditures eligible for the incremental credit must meet the definition of "research or experimental ex-

[8] The Code provides a single research credit, consisting of a 20-percent incremental component and a 20-percent university basic research component. For convenience, this explanation generally refers to these components as the incremental research credit and the university basic research credit.

penditures" eligible for expensing under section 174 (see description above) and the additional requirements and limitations set forth in section 41. Thus, for example, pursuant to the section 174 limitations, the credit is not available for (1) expenditures other than "research and development costs in the experimental or laboratory sense," (2) expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions," (3) costs of acquiring another person's patent, model, production, or process, or (4) research expenditures incurred in connection with literary, historical, or similar projects (Treas. Reg. sec. 1.174-2(a)).[9]

Research satisfying the section 174 expensing definition is eligible for the credit only if the research is undertaken for the purpose of discovering information (a) that is technological in nature, and also (b) when applied is intended to be useful in the development of a new or improved business component of the taxpayer. In addition, such research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a functional purpose.

The Code also expressly sets forth exclusions from eligibility for the credit for certain research activities that might otherwise qualify and for certain nonresearch activities, including post-production research activities, duplication or adaptation costs, and surveys, studies, and certain other costs. The costs of developing certain internal-use software are available for the credit only if specified requirements are met. The credit does not apply to any research to the extent funded by any grant, contract, or otherwise by any person or governmental entity.

***Computation of allowable credit***

*General rule.*—As a general rule, the incremental credit applies to the amount of qualified research expenditures for the current taxable year that exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

*New businesses.*—For purposes of computing average annual research expenditures during the base period, a new business is treated as having research expenditures of zero for a year during which it was not in existence. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

*50-percent limitation rule.*—Base period research expenditures are deemed to be at least equal to 50 percent of qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.[10]

---

[9] Sec. 174 also excludes from eligibility for expensing (1) expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research, and (2) expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas.

[10] For example, assume that a calendar-year taxpayer is organized on January 1, 1986; makes qualified research expenditures of $100,000 for 1986; and makes qualified research expenditures

Continued

*Aggregation rules.*—To ensure that the credit is allowed only for actual increases in research expenditures, special rules provide that research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled businesses.

*Changes in business ownership.*—Special rules apply for computing the credit where a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

***Trade or business limitations***

The incremental credit is available only for research expenditures paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. With one exception relating to certain research joint ventures, the trade or business test for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. As a result, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on (within the meaning of sec. 162) by the taxpayer.

Thus, under present law no credit is available to a start-up company for research the results of which are intended to be used in its future business activities, or to an existing business for research expenditures incurred for purposes of developing a new line of business. Also, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner which is an operating company) for partnership expenditures for outside or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments.

***Other limitations and carryover***

The research credit is subject to the general business credit limitation (i.e., the credit cannot reduce the taxpayer's tax liability to less than the greater of the taxpayer's tentative minimum tax or 25 percent of the taxpayer's tax liability over $25,000). Any excess amount of the general business credit can be carried back three years and carried forward 15 years, beginning with the earliest year.

---

of $260,000 for 1987. The new-business rule provides that the taxpayer is deemed to have base period expenditures of zero for pre-1986 years. Without regard to the 50-percent limitation, the taxpayer's base period expenditures for purposes of determining any credit for 1987 would be the average of its expenditures for 1984 (deemed to be zero), 1985 (deemed to be zero), and 1986 ($100,000), or $33,333. However, by virtue of the 50-percent limitation, the taxpayer's average base period expenditures are deemed to be no less than 50 percent of its current year expenditures ($260,000), or $130,000. Accordingly, the amount of 1987 qualified research expenditures to which the credit applies is limited to $130,000, and the amount of the taxpayer's credit for 1987 is 20 percent of $130,000, or $26,000.

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest.[11] Any excess credit amount is eligible for the carryover rule described above.

***Relation to deduction***

The section 41 credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to deduct currently research expenditures. Under present law, the amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for the same research expenditures.

***University basic research credit***

A 20-percent tax credit also applies to the amount by which corporate cash expenditures (including grants or contributions) paid for university basic research exceed the sum of (1) the greater of two fixed research floors plus (2) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.

The amount of basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation, provided that such expenditures are eligible for the incremental credit.

## *Explanation of the Bill*

***a. Extension of credit***

The bill would make permanent the incremental research credit and the university basic research credit.

---

[11] For example, if in a particular year an individual partner derives no taxable income from a partnership which had made incremental qualified research expenditures, the individual may not use in that year any tax credit resulting from incremental qualified research expenditures of such partnership which otherwise would have been properly allowable to the partner (e.g., where the partnership had paid such research expenditures in carrying on a trade or business of the partnership and where any credit allowable to the partnership with respect to such expenditures had been properly allocated among the partners pursuant to Treasury regulations). If, in this example, the partner had derived taxable income allocable or apportionable to his or her partnership interest, then the amount of credit which may be used in that year by the individual partner may not exceed the lesser of (1) the general business credit limitation amount or (2) the separately computed additional limitation amount applicable to individuals, i.e., the amount of tax owed by the partner on income attributable to his or her partnership interest.

***b. Modification of base period for incremental credit***

***In general***

Under the bill, a taxpayer could elect either of two methods for computing the incremental research credit. Under either method, a specified credit rate would apply to the amount of the taxpayer's qualified research expenditures in the current year that exceeds a fixed base period amount (subject to certain adjustments), rather than a moving base period amount as under present law.

Under the first method (the "primary credit"), the base period amount would equal the average of the taxpayer's yearly qualified research expenditures for its taxable years beginning after December 31, 1982 and before January 1, 1988, with two adjustments. The five-year base period amount would be increased by seven percent; this would be a one-time only adjustment. In addition, the base period amount as so computed would be increased each year to reflect the GNP growth rate.[12] If the primary credit is elected, a credit rate of 20 percent would apply to those qualified research expenditures in the current taxable year that exceed the base period amount.

Under the second method (the "alternative credit"), the base period amount would equal 75 percent of the base period amount as computed under the first method. If the taxpayer elects this method, the credit rate would be seven percent.

In any taxable year, a taxpayer can elect either the primary credit or the alternative credit, depending on which method results in the greater credit amount, regardless of the method selected by the taxpayer in the previous year.

***New companies***

A special rule would apply to determine the base period amount in the case of a taxpayer which did *not* have qualified research expenditures in at least three of the five years in the fixed base period (i.e., taxable years beginning after 1982 and before 1988). This rule would apply both to businesses formed after 1988 and to existing businesses that meet the definition (e.g., a business incorporated in 1984 that prior to 1988 had qualified research expenditures only in 1986 and 1987).

For such a new business, the base period amount would be computed as follows:

For the first taxable year (beginning after 1988) in which the firm incurs qualified research expenditures, and for each of the two succeeding years, the taxpayer's base would be deemed to be equal to 50 percent of its current year qualified research expenditures.

For the fourth year, the taxpayer's base would be deemed equal to the greater of (1) 50 percent of its current year qualified research expenditures or (2) one-third of the average of the taxpayer's actual yearly qualified research expenditures in the first three

---

[12] The GNP growth rate means the nominal growth rate of the GNP published by the Bureau of Economic Analysis of the Department of Commerce. The adjustment to the base period would be the percentage (if any) by which GNP for the calendar year preceding the calendar year in which the taxable year begins exceeds GNP for the previous calendar year.

years, as adjusted to reflect any increase in GNP between the third and fourth year.

For the fifth year, the taxpayer's base would be deemed equal to the greater of (1) 50 percent of its current year qualified research expenditures or (2) the sum of (a) the base period amount applicable to year four plus (b) 15 percent of the taxpayer's actual qualified research expenditures in year four, with the sum adjusted to reflect any increase in GNP between the fourth and fifth year.

For the sixth year, the taxpayer's base would be deemed equal to the greater of (1) 50 percent of its current year qualified research expenditures or (2) the sum of (a) the base period amount applicable to year five plus (b) 15 percent of the taxpayer's actual qualified research expenditures in year five, with the sum adjusted to reflect any increase in GNP between the fifth and sixth year.

For the seventh year and subsequent years, the taxpayer's base would equal the base period amount applicable to the prior ↔ year, as adjusted to reflect any increase in GNP from the prior year. As under present law, the taxpayer's base period amount could not be less than 50 percent of its current-year expenditures, regardless of which credit computation method is selected.

### *c. Extension of credit to start-up businesses*

#### *In general*

Under the bill, in-house research expenditures would be treated as meeting the "carrying on" test if the taxpayer's principal purpose in making such expenditures is to use the research results in the active conduct of a future trade or business of the taxpayer. Thus, otherwise qualified in-house research expenditures of a start-up firm whose activities have not yet reached the point of constituting a trade or business would be eligible for the credit. (However, contract research expenditures would be eligible for the credit only pursuant to the present-law trade or business test.) If in the year the credit is earned the start-up firm does not have any income tax liability against which the credit could be used, this credit amount would be eligible for the 15-year carryover (subject to the general business credit limitation) provided under current law.

#### *Limitations*

The bill would not modify the present-law rule that the credit is not available to any partners (whether businesses or investors) in a partnership that does not meet the trade or business test at the partnership level.

Under the bill, as under present law, base period research expenditures would be treated as at least equal to 50 percent of qualified research expenditures for the current year.

Also, the bill would not affect the special present-law limitation on use of the credit by individuals. Under that limitation, in the

case of an individual who owns an interest in an unincorporated trade or business, is a partner in a partnership, is a shareholder in an S corporation, or is a beneficiary of a trust or estate, the amount of credit that can be used in a particular year cannot exceed an amount (separately computed with respect to the person's interest in the business or entity) equal to the tax attributable to that portion of the individual's taxable income that is allocable or apportionable to such interest.

### *Effective Date*

The provisions would be effective for taxable years beginning after December 31, 1988.

## 6. S. 2611—Senator Cranston

### Disclosure of Certain Tax Return Information to Veterans' Administration

#### *Present Law*

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, with exceptions for authorized disclosure in certain enumerated instances (Code sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Among the disclosures permitted under the Code is disclosure of return information to Federal, State, and local agencies administering certain programs under the Social Security Act or the Food Stamp Act of 1977. This disclosure, pursuant to a written request by the agency, is for the purpose of determining eligibility for, and the correct amount of benefits under, certain enumerated programs. Any authorized recipient of return information must maintain a system of safeguards to protect against unauthorized redisclosure of the information.

#### *Explanation of the Bill*

The bill[13] would allow disclosure of certain tax return information to the Veterans' Administration to assist it in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension and other programs.

The Veterans' Administration would be required to comply with the safeguards presently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

#### *Effective Date*

The bill would be effective on the date of enactment.

---

[13] S. 2611 was favorably reported by the Senate Committee on Veterans' Affairs on July 6, 1988 (S. Rpt. 100–412), and was placed on the Senate Calendar.

## 7. H.R. 1961

## Portability of Pension Plan Benefits

### *Background*

There is no precise definition of portability of pension benefits, and the term is often used to refer to a broad range of concepts. In general terms, portability refers to the ability to maintain pension benefits following a change in employment. In order to evaluate any pension portability proposal, it is helpful to understand what is meant by portability, and what aspect of portability any particular proposal means to address.

The most discussed concepts of portability generally fall into three categories: (1) portability of benefits, which generally refers to vesting; (2) portability of service (also sometimes called portability of credited service or portability of service history), which refers to the ability to count years of service under a plan of a prior employer in determining benefits under a plan of a new employer; and (3) portability of assets (also sometimes called portability of current or present value), which refers to the ability to maintain a distribution of benefits in another retirement arrangement.

In addition, issues of coverage (i.e., what employees are covered under private pension plans) and preservation of benefits (i.e., whether an individual saves a distribution of retirement benefits or spends the distribution for preretirement purposes) often arise in discussions on portability. H.R. 1961 (described below) generally relates to portability of assets and coverage issues.

### *Present Law*

#### *In general*

Under present law, the pension system that provides the greatest degree of portability is the social security system. The social security system provides almost universal coverage for all workers, and benefits are based on all covered employment. Outside the social security system (i.e., in the private pension system), present law requires portability of service in limited circumstances. There are a number of provisions of present law which facilitate portability of assets, the most significant being the ability to roll over distributions to an individual retirement arrangement (IRA). In addition, the withdrawal restrictions applicable to tax-qualified retirement plans, as well as the rules regarding taxation of benefits, are generally designed to provide incentives to individuals to save pension benefits for retirement purposes, and not spend them for preretirement uses.

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), an

employer is allowed a deduction for contributions (within limits) to a trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. A qualified plan may be a pension, profit-sharing, or stock bonus plan.

An employer's deductions and an employee's benefits under a qualified plan may be limited by reference to the employee's compensation. The Code also imposes overall limits on benefits or contributions that may be provided under qualified plans.

Under a qualified plan, employees do not include benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

In addition, employees may make after-tax contributions to a qualified plan and defer taxation on the earnings on such contributions until distribution from the plan. An employee may also make elective deferrals to a qualified plan on a salary reduction basis. Elective deferrals are excludable from gross income when made, and are not taxed until distributed from the plan.

Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of highly compensated employees. In addition, qualified plans are required to meet minimum standards relating to coverage (what employees participate in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made to ensure the solvency of pension plans.

A simplified employee pension (SEP) is another type of tax-favored retirement arrangement under which the employer contributes directly to an IRA established for the employee. A contribution must be made for each employee who is at least age 21, has performed service during at least three of the immediately preceding five years, and received at least $300 of compensation from the employer. Contributions must bear a uniform relationship to compensation. Under the Tax Reform Act of 1986, employers with less than 25 employees may establish SEPs on a salary reduction basis. Like qualified plans, contributions to SEPs are excludable from income and earnings accumulate on a tax-deferred basis.

***Portability of assets***

***In general***

There are a number of provisions in present law that facilitate portability of assets. Present law encourages portability by permitting assets to be rolled over or to be transferred from one tax-favored retirement arrangement to another, and by providing incentives to individuals to save amounts received from retirement plans for retirement purposes.

*IRA rollovers*

An individual may generally roll over a distribution received from a qualified plan to an IRA if (1) the distribution is a total distribution of the individual's entire interest in the plan, or (2) the distribution is a qualified partial distribution. To the extent a distribution is rolled over into an IRA, it is not includible in income and is not subject to the 10-percent additional income tax on early distributions (see below). Of course, when such amounts are subsequently distributed from the IRA, they are includible in income and subject to the 10-percent additional income tax unless an exception to the tax applies. Only employer contributions (and income on employer or employee contributions) can be rolled over to an IRA. Distributions of employee contributions cannot be rolled over.

A total distribution may be rolled over to an IRA if it is made (1) because of the death of the individual; (2) after the individual has attained age 59-1/2; (3) because of termination of employment (other than in the case of a self-employed person); or (4) in the case of self-employed persons only, after the individual becomes permanently disabled. In the case of these distributions, a distribution is a total distribution only if it includes the individual's complete share in all of the employer's pension plans, or profit-sharing plans, or stock bonus plans. That is, for this purpose, all plans of the same type are treated as a single plan.

A total distribution may also be rolled over if it is made because of a termination of a plan. In order to qualify as a partial distribution, a distribution must be at least 50 percent of the individual's interest in the plan and meet certain other requirements.

Tax-free rollovers and transfers between IRAs are permitted, although certain restrictions may apply.

*Rollovers and transfers to another qualified plan*

Distributions from qualified retirement plans can generally be rolled over to another qualified plan or transferred to another qualified plan on the same basis that distributions can be rolled over to an IRA, except that partial distributions may only be rolled over to an IRA. Present law does not require that plans permit transfers or rollovers from another qualified plan. Plan provisions permitting such transactions are likely to be most prevalent in the case of related companies or where there has been a merger or acquisition.

*Incentives to retain funds for retirement purposes*

In some cases, present law restricts the ability of employees to obtain a distribution from a qualified retirement plan prior to termination of employment. In the case of pension plans, i.e., defined benefit plans and money purchase pension plans, distributions cannot be made prior to termination of employment. Elective contributions to qualified cash or deferred arrangements (sec. 401(k) plans) cannot be distributed prior to termination of employment, attainment of age 59-1/2, death, disability, or financial hardship. Contributions to profit-sharing and stock bonus plans generally can be distributed within two years of when they were contributed.

Employee contributions generally may be withdrawn at any time. A plan may impose stricter restrictions on plan distributions than those imposed by the qualification rules.

The qualification rules generally require that a distribution be available upon the attainment of normal retirement age. Whether an employee who terminates employment prior to normal retirement age has the right to obtain a current distribution of the value of his or her benefit depends on the terms of the plan. Defined contribution plans generally permit a distribution of the employee's account balance upon termination of employment. In defined benefit plans, there are not separate accounts for each individual and, as a result, distributions often are not available until retirement age. Some defined benefit plans prefer not to make lump-sum distributions, because doing so can affect the funded status of the plan.

If the present value of the employee's benefit does not exceed $3,500, the benefit may be distributed upon termination of employment to the individual, without the individual's consent. Many plans, including both defined contribution plans and defined benefit plans, will cash out benefits of less than $3,500 because the employer will want to avoid the administrative burdens of keeping track of small benefits for former employees.

If the present value of the individual's benefit exceeds $3,500, then the benefit cannot be distributed prior to the later of normal retirement age or age 62, unless the participant consents to the distribution. Thus, participants with larger benefits have the option of deferring a plan distribution until retirement age.

***Taxation of distributions***

A number of rules regarding taxation of distributions are designed to encourage individuals to save distributions for retirement purposes rather than use them for current consumption.

For example, the Tax Reform Act of 1986 (the 1986 Act) added a 10-percent additional income tax on all early distributions from qualified retirement plans, including IRAs. Prior to the 1986 Act, a similar 10-percent tax applied to early distributions from IRAs and early distributions to certain "key employees," such as five-percent owners, from a qualified plan.

The tax is an additional income tax, so it only applies to the portion of a distribution includible in income. Thus, the tax does not apply to distributions of employee contributions or to the portion of a distribution that is rolled over to another qualified plan or an IRA.

In addition, the additional tax does not apply to distributions (1) after attainment of age 59-1/2; (2) due to the death of the individual; (3) due to the disability of the individual; (4) used to pay medical expenses that would be deductible if the individual itemized deductions (not applicable to IRAs); (5) that are part of a series of substantially equal periodic payments made for the life or life expectancy of the individual (or the joint lives or joint life expectancies of the individual and his or her spouse); (6) made in the case of an employee who separated from service after attainment of age 55 (not applicable to IRAs); (7) from an employee stock ownership

plan; or (8) made pursuant to a qualified domestic relations order (not applicable to IRAs).

Other changes in the 1986 Act were also designed to reduce the incentive to take distributions prior to retirement. Under the law prior to the 1986 Act, an individual who received a lump-sum distribution could elect to apply 10-year income averaging to the distribution, which treated the distribution as if it had been received over a 10-year period. In addition, under prior law, the portion of a lump-sum distribution attributable to contributions prior to January 1, 1974, could qualify for treatment as long-term capital gains.

The 1986 Act phased out long-term capital gain treatment over six years and replaced 10-year forward averaging with five-year forward averaging. In addition, averaging may be elected only after the individual has attained age 59-1/2, and only one such election may be made.

### *Explanation of the Bill*

#### *In general*

H.R. 1961[14] modifies the rules relating to distributions from qualified plans (sec. 401(a)), qualified annuity plans (sec. 403(a)), tax-sheltered annuity contracts (sec. 403(b)), and IRAs (sec. 408). Generally, the bill provides that (1) in certain circumstances, direct transfers to IRAs are required in lieu of distributions; (2) the Treasury Department may permit the distribution of employee contributions to be rolled over; (3) distributions from IRAs must be made with the consent of the IRA owner; (4) certain spousal rights to survivor benefits are required for IRAs and tax-sheltered annuity contracts; (5) certain nontax provisions are made applicable to pension plans consisting of one or more IRAs; and (6) the rules relating to salary reduction SEPs are modified.

#### *Transfers*

In general, the bill requires that single-sum distributions to employees or their spouses from qualified plans, qualified annuity plans, and tax-sheltered annuity contracts (qualified retirement plans) be made in the form of a direct trustee-to-trustee transfer to an IRA. This requirement does not apply, however, if (1) the present value of the employee's accrued benefit exceeds $3,500, (2) a different form of benefit is elected, and (3) commencement of payment of the benefit is not deferred. This requirement also generally does not apply to governmental plans, church plans, certain frozen plans, and certain plans to which employers do not contribute.

The bill also requires that an individual be permitted to transfer IRA assets to another IRA or to a qualified retirement plan that accepts such transfers.

---

[14] H.R. 1961 was reported, with amendments, by the House Committee on Education and Labor on June 7, 1988 (H.Rpt. 100–676, Part 1). The bill was referred jointly to the Committee on Education and Labor and the Committee on Ways and Means.

H.R. 1961, as reported, has the same provisions as S. 2343 (Senator Quayle).

*Rollovers*

Under the bill, the Treasury Department may permit distributions from qualified retirement plans of employee contributions to be rolled over to another such plan or to an IRA.

*IRA distributions*

Under the bill, certain assets in IRAs may not be distributed without the consent of the IRA owner. The assets subject to this rule are assets transferred from a qualified retirement plan and assets in a SEP. An exception is provided for distributions in the form of a 50-percent qualified joint and survivor annuity or a single life annuity to the extent that such distributions are required by the minimum distribution rules.

*Spousal rights*

Present law provides an individual with certain rights to survivor benefits with respect to his or her spouse's interest in qualified plan assets. The bill extends these rights to IRAs and tax-sheltered annuity contracts by treating such arrangements as nonpension defined contribution plans. However, with respect to IRAs, such treatment only applies to assets transferred from a qualified retirement plan and assets in a SEP.

*IRA pension plans*

The bill provides that pension plans consisting of one or more IRAs are subject to certain requirements under Title 1 of ERISA. Generally, IRA pension plans are to be treated as other pension plans under Title 1, except that the funding rules do not apply and only certain rules under Part 2 (generally relating to participation and vesting) apply. In general, the rules applicable under Part 2 are (1) the participation rules (with special rules for SEPs); (2) the prohibition on alienation or assignment; and (3) the vesting rules (with the modification that all interests must be 100 percent vested).

*Salary reduction SEPs*

Under certain circumstances, the bill allows employers to establish a new type of SEP that permits employees to reduce their salary and contribute the amount of such reduction to the SEP. This alternative arrangement is available to employers (other than State or local governments or tax-exempt organizations) not otherwise maintaining a qualified plan or qualified annuity plan. Under the bill, such salary reduction SEPs are subject to nondiscrimination rules that are similar to, but less restrictive than, the rules applicable under present law to salary reduction SEPs. The bill also modifies certain other nondiscrimination requirements for all SEPs, without regard to whether they allow salary reduction.

*Effective Date*

The bill is effective for plan years and taxable years beginning after December 31, 1991.

## 8. H.R. 2792

### Tax Treatment of Indian Fishing Rights

#### *Present Law*

Various treaties, Federal statutes, and executive orders reserve to Indian tribes (mostly in the West and Great Lakes regions) rights to fish for subsistence and commercial purposes both on and off reservations. Because the treaties, statutes, and executive orders were adopted before passage of the Federal income tax, they do not expressly provide whether income derived by Indians from protected fishing activities is exempt from taxation.

Indians generally are subject to Federal tax in the same manner as other U.S. citizens, absent a specific Federal exemption. Consequently, the Tax Court has ruled in three cases that income derived by Indians from protected fishing activities is taxable, and the Internal Revenue Service has assessed deficiencies in other cases.

#### *Explanation of the Bill*

The bill[15] would provide that income derived by individual members of an Indian tribe, or by a qualified Indian entity, from fishing rights-related activity is exempt from Federal and State tax, including income, social security, and unemployment compensation insurance taxes.[16] Fishing rights-related activities would be defined as any activity by a tribe or members of that tribe directly related to harvesting, processing, or transporting fish harvested in the exercise of fishing rights guaranteed to that tribe by treaty, Federal statute, or executive order.

The bill would define a "qualified Indian entity" as an entity in which (1) all of the equity interests are owned by tribal members; (2) substantially all of the management functions are performed by tribal members; and (3) if the entity engages in any substantial processing or transporting of fish, at least 90 percent of the annual gross receipts are derived from the exercise of protected fishing

---

[15] H.R. 2792 was passed by the House of Representatives on June 20, 1988. (See also H.Rpt. 100–312, Part 2.)

[16] Individuals may derive exempt income through self-employed activities, as employees, or as owners of qualified Indian entities.

rights.[17] An entity that failed to satisfy any of the criteria of a qualified Indian entity would not be eligible for the exemption from tax provided by the bill; any employee or owner of such an entity would not be eligible under the bill for tax exemption on income received from such entity.

In the case of an individual tribal member or a qualified Indian entity, the bill would exempt from taxation only that income "derived" from fishing rights-related activities. Thus, both individual tribal members and qualified Indian entities would be required to allocate income and expenses among fishing rights-related activities and all other activities.[18] Expenses and amounts otherwise deductible that were attributable to income that would be exempt under the bill could not be used by an individual or entity to offset any other income of the individual or entity. Likewise, income that is exempt from tax under the bill would be excluded in determining whether an individual was eligible for social security benefits or unemployment compensation.

Income from Indian fishing activities protected by treaty, Federal statute, or executive order would be exempt from Federal taxes only to the extent provided for by the bill. If income from fishing rights-related activity is exempt from Federal tax, then the bill would prohibit imposition under State or local law of any tax on such income. (However, the bill would not limit exemptions from State and local taxes that may be broader than the exemption it provides.)

### *Effective Date*

The bill would apply to all taxable years beginning before or after the date of enactment as to which the period of assessment has not expired.

---

[17] A qualified Indian entity may be jointly owned by members of more than one Indian tribe, provided that the entity is engaged in fishing rights-related activity of each tribe of which the owners are members. If a jointly owned entity engages in substantial processing or transporting of fish, at least 90 percent of the annual gross receipts must be derived from fishing rights-related activities of tribes whose members own at least 10 percent equity interests in the entity. The bill does not affect the income of a tribal government received pursuant to the exercise of an essential governmental function (see Code secs. 115 and 7871; Rev. Rul. 67-284, 1967-2 C.B. 55, 58). However, wages paid to an Indian who was employed by an entity that was owned by his or her tribal government and that engaged in fishing rights-related activities could be exempt from tax under the bill only if the entity satisfied the bill's criteria for a qualified Indian entity (treating the tribal government's ownership as ownership by tribal members).

[18] However, allocations between exempt and taxable income would not be required where all but a de minimis amount of the income of the individual or entity was derived from protected fishing activities.

○